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CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 453

COMMERCIAL DISCOUNT COMPANY,

Petitioner,

vs.

ETHEL STRICKLAND ROGAN, Executrix of the Last Will and Testament of Nat Rogan, Deceased,

Respondent.

Petition for Writ of Certiorari to the Circuit Court of Appeals for the Ninth Circuit, and Brief in Support Thereof.

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Respondent.

Petition for Writ of Certiorari to the Circuit Court of Appeals for the Ninth Circuit.

To the Honorable the Chief Justice and Associate Justices of the Supreme Court of the United States:

COMMERCIAL DISCOUNT COMPANY, a corporation, respectfully petitions that a writ of certiorari issue to review the final judgment of the Circuit Court of Appeals for the Ninth Circuit in that certain cause therein entitled "Ethel Strickland Rogan, Executrix of the last will and testament of Nat Rogan, Deceased, Appellant, vs. Commercial Discount Company, Appellee," being

therein number 10,844. Said judgment was entered by said Circuit Court of Appeals on May 25, 1945 [R. 145]. A petition for rehearing was filed by Commercial Discount Company within the time allowed therefor by rule of court, and an order denying said petition for rehearing was filed on June 29, 1945 [R. 146].

Opinion Below.

The opinion of the Circuit Court of Appeals for the Ninth Circuit in this cause is set forth in full at R. 131.

Jurisdiction.

The jurisdiction of this court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A. §347(a)).

This petition is made pursuant to Paragraph 5(b) of Rule 38 of the Rules of this court, and in particular the part thereof which suggests that a writ of certiorari may be issued where a Circuit Court of Appeals has decided an important question of federal law which has not been, but should be, settled by this court.

The cause sought to be reviewed herein involves the decision of an important question of national importance concerning the proper construction and application of the Internal Revenue Code and in particular the authority of the Commissioner of Internal Revenue to deny to a taxpayer using the reserve method for treatment of bad debts the right to claim the deduction permitted by the Code and thus to pay taxes only on net income.

Questions Presented.

1. May a taxpayer who has established the reserve method for treating bad debts deduct from gross income a reasonable addition to such reserve account "only to the extent of the amount of the debts which have been ascertained to be wholly or partially worthless and charged against the account during the taxable year"[1]?

2. Must a taxpayer using the reserve method for treating bad debts, as a prerequisite to the right to deduct additions to the reserve, comply with that portion of Section 23(k)[2] of the Revenue Act of 1934 which requires ascertainment of worthlessness and charge-off during the taxable year?

3. Does Art. 23(k)[3] of Treasury Regulations 86 (promulgated under the Revenue Act of 1934) require that a taxpayer using the reserve method of treating bad debts must, as a prerequisite to deducting additions to the reserve, ascertain worthlessness and charge-off within the taxable year?

4. May a taxpayer who has established the reserve method for treating bad debts be denied the rights granted to taxpayers generally by Section 322(a)(1) of the Internal Revenue Code to recover, through claim for refund, taxes paid through inadvertence or mistake?

5. Is a taxpayer who has established the reserve method for treatment of bad debts entitled, through a claim for refund, to recover taxes overpaid where the overpayment was due to an erroneous under-statement of the amount reasonably needed in the reserve account?

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[1]As stated by the Circuit Court of Appeals [R. 138].
[2]Quoted on page 12 of Supporting Brief.
[3]See Appendix, pages 29-31.

Summary Statement of Matter Involved.

Petitioner, Comercial Discount Company, a California corporation, prior to March 15, 1938, executed and filed with respondent a claim for refund of federal income taxes paid for the year 1934 [R. 7, 8, 12, 42]. Thereafter, said claim was disallowed [R. 7, 42] and, following notice of such disallowance, petitioner filed this action. The trial court gave judgment for petitioner [R. 45] and, upon appeal by respondent, the Circuit Court of Appeals reversed [R. 145].

Only the following facts involved in this proceeding need be stated to raise the issues that petitioner calls to the attention of this court:

Petitioner's principal business since prior to the year 1934 has been the purchase of contracts for the conditional sale of automobiles and the collection of payments falling due under such contracts [R. 5, 23]. Petitioner has since prior to the year 1934 followed the practice of deducting from income, on its income tax returns, additions to a reserve account for bad debts, rather than deducting specific bad debts ascertained to be worthless [R. 59].

On or about May 15, 1934, the Hollywood Improvement Co. was indebted to petitioner in the amount of $194,513.94 [R. 4, 40]. According to the terms of the promissory note evidencing the indebtedness, the Improvement Co. was not to be personally liable on said note or for any deficiency following sale under or foreclosure of the deed of trust securing the same [R. 3, 40].

Default having occurred under the terms of the promissory note and the deed of trust, petitioner entered into

negotiations with the Improvement Co. for the acquisition of title to the property covered by the deed of trust by means of a voluntary deed in lieu of proceedings for trustee's sale or foreclosure, and on or about May 15, 1934 such conveyance was made in satisfaction of said indebtedness [R. 4, 40].

The property so received had a value on that date of $70,000 [R. 105] and petitoner then and there suffered an actual loss of $124,513.94 [R. 4, 40]. Such loss was one outside the usual and ordinary course of petitioner's business [R. 41].

For the year 1934 petitioner made on its books, and deducted from gross income on its federal income tax return, an addition to its reserve for bad debts in the aggregate amount of $49,595.44 [R. 41, 81]. In determining the amount of said addition to bad debt reserve for such year, petitioner did not take into consideration and did not make any allowance for said loss of $124,513.94 [R. 41, 81-82] for the reason that petitioner did not at that time construe the transaction as one giving rise to a bad debt loss, and improperly analyzed it for tax purposes as a purchase of the property [R. 41, 70-71].

Petitioner has never claimed in or in connection with its income tax liability for any year other than 1934, any deduction or allowance of said loss [R. 41-42, 82].

The trial court found that at the end of the year 1934 petitioner knew that said indebtedness no longer existed, and that the amount by which the total indebtedness exceeded the market value of the property received in lieu of foreclosure could not be collected or recovered from the Hollywood Improvement Co. [R. 43]; that the sum of $49,595.44, plus the sum of $124,513.94, making a total

sum of $174,101.38, was a reasonable addition to petitioner's reserve account for bad debts which should have been made for the year 1934 [R. 41]; and gave judgment for petitioner [R. 45].

The Circuit Court of Appeals, in reversing the trial court, apparently held that those provisions of Section 23(k) of the Revenue Act of 1934, which expressly relate to taxpayers on the "charge-off" method of treating bad debts, apply likewise to taxpayers on the reserve method, and that since the petitioner failed during the taxable year to ascertain the *amount* of its loss and charge off or make appropriate entries on its books during the taxable year reflecting such loss, all rights to consider such loss in computing net income for such tax year were forever lost.

Specification of Errors.

The Circuit Court of Appeals erred:

1. In holding that the only amount that may be added to bad debt reserve is exactly the amount of bad debts ascertained to be worthless and charged off during the year; thus nullifying one of the alternative methods of treating bad debts authorized by the statute;

2. In applying to a taxpayer on the reserve method of treating bad debts, those portions of Section 23(k) of the Revenue Act of 1934 and of Treas-

ury Regulations 86, Article 23(k), which relate solely to taxpayers on the charge-off method;

3. In failing to distinguish inherent differences between the charge-off and reserve methods;

4. In failing to recognize that for taxpayers on the reserve method the authorized deduction from income is an addition to the reserve which may take into consideration, but is not exclusively measured by, specific bad debts;

5. In holding (if it did so hold) that petitioner was attempting, through a claim for refund, to deduct retroactively a specific bad debt;

6. In holding that petitioner by this action was seeking to obtain a deduction for a specific bad debt;

7. In failing to hold that the decisions of other courts determining the rights of taxpayers on the charge-off method necessarily apply principles foreign to the issues of the case at bar;

8. In holding that a taxpayer on the reserve method of treating bad debts must, as a condition to the taking of the authorized deduction, make book entries during the taxable year showing a credit to the reserve for bad debts;

9. In failing to hold that petitioner did not lose its right to the deduction merely because it failed to set up the same on its books or claim it at the time of filing its return.

Reasons for Granting the Writ.

1. The decision of the Circuit Court of Appeals, holding that a taxpayer on the reserve method loses all right to claim a deduction because of bad debts unless he ascertains their worthlessness and charges off the debt or makes other book entries thereon during the taxable year, involves an important question of federal law which has not been, but should be, settled by this Honorable Court.

It is believed that this question is a highly important one. It involves the proper construction of a federal statute governing the right of many taxpayers to claim deductions and to file claims for refund on account of bad debt losses. It is respectfully submitted that the Circuit Court of Appeals' decision constitutes a judicial repeal of Congressional grant to taxpayers of the right to use either one of two alternative methods of treating bad debts for income tax purposes; and that it further nullifies the right granted by Section 322(a)[4] of the Revenue Act of 1934 and subsequent acts to a taxpayer, through claim for refund, to correct errors and mistakes and to determine proper tax liability.

Our research has not disclosed any proceeding, prior to the instant one, in which this question has been squarely presented for decision either to the Circuit Court of Appeals or to this Honorable Court.

2. The decision of the Circuit Court of Appeals is contrary to the practice of the Commissioner, as is disclosed by the record in this proceeding [R. 98-103], and is contrary to the results reached by the Board of Tax

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[4]See Appendix, page 29.

Appeals in two decisions that have come to our attention, one of which was affirmed by the Circuit Court of Appeals.[5]

Petitioner respectfully represents that said questions properly appear in the record and were raised before the trial court and the Circuit Court of Appeals.

Wherefore, your petitioner respectfully prays that a Writ of Certiorari issue out of and under the Seal of this Honorable Court directed to the Circuit Court of Appeals for the Ninth Circuit, requiring said court to certify and send to this court a full and complete transcript of the record and of the proceedings in said Circuit Court of Appeals in the case therein numbered 10,844, and entitled "Ethel Strickland Rogan, Executrix of the last will and testament of Nat Rogan, Deceased, Appellant, vs. Commercial Discount Company, Appellee," to be reviewed and determined by this Honorable Court, as provided by law; that the judgment of said Circuit Court of Appeals herein be reversed by this Honorable Court; and for such further relief as to this Court may seem proper.

Dated: September 21, 1945.

MAYNARD J. TOLL,
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Of Counsel.

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[5]See footnote 8, p. 24, of Supporting Brief.

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Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.
SUMMARY OF ARGUMENT.

A. Congress has authorized two methods for the treatment of bad debt deductions: (1) ascertainment and charge-off, and (2) the reserve method. The two methods are inherently and basically different.

B. The rationale of the decision below destroys all distinction between the two methods of treating bad debts which Congress has authorized.

C. Neither the statutes, the regulations nor administrative practice requires of a taxpayer on the reserve method that there be any "ascertainment," "charge-off," or book entries during the taxable year.

D. The petitioner does not seek an enlargement or addition to reserve in light of subsequent events; rather it seeks to apply the general principle that net income should be computed and taxes paid on an annual basis.

E. Congress did not intend that a taxpayer should be denied the right to deduct items otherwise deductible because of mere inadvertence or ignorance of the law.

II.
ARGUMENT.

A. Congress Has Authorized Two Methods for the Treatment of Bad Debt Deductions: (1) Ascertainment and Charge-off and (2) the Reserve Method. The Two Methods Are Inherently and Basically Different.

Section 23 of the Revenue Act of 1934 provides that:

"In computing net income there shall be allowed as deductions: * * *

"(k) *Bad debts.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to the reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction."

The charge-off method deals exclusively with specific bad debt items, and inherent in the process of use of such method is ascertainment of worthlessness and charge-off of specific bad debts. Such ascertainment and charge-off are expressly required of taxpayers using such method, both by the statute and regulations.[6] In the reserve method, the reserve operates as a valuation account and is an offset against the *total balance* in the accounts receivable, rather than against specific receivables.

The use of the reserve method deals with both realized and reasonably *anticipated* losses from bad debts. Inherent in this method, in contrast to the charge-off method, is the fact that a reasonable deduction may be made for losses which have not yet occurred, and so far as particular items are concerned, may never occur.

In authorizing the use of this method Congress provided, again in contrast to the deduction of specific bad debts, that reasonable additions to the reserve should be deductible from gross income.

Accounting and procedural steps authorized in the two methods are inherently and necessarily opposite and antagonistic, and regulations referring to one may not, with reason, be considered as referring to or controlling the other.

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[6]Since passage of the Revenue Act of 1942 the deduction, on this method, depends only upon the *fact* of worthlessness of specific bad debts. See Internal Revenue Code, Sec. 23(k), as amended.

B. The Rationale of the Decision Below Destroys All Distinction Between the Two Methods of Treating Bad Debts Which Congress Has Authorized.

In its opinion the Circuit Court of Appeals emphasized the controlling effect of administrative regulations [R. 137, footnote 3]. It then stated the principle, based on Art. 23(k)-5 of the Regulations 86,[7] which it held applicable to the instant case, as follows:

> "Finally they provide that a taxpayer who has established the reserve method of treating bad debts and maintained proper reserve accounts therefor may deduct from gross income a reasonable addition to such reserve in lieu of a deduction for specific bad debt items, only to the extent of the amount of 'the debts which have been ascertained to be wholly or partially worthless and charged against the reserve account during the taxable year.'"

That such a principle would amount to a repeal of that portion of Sec. 23(k) which authorizes the reserve method is easily demonstrated.

The existence of two alternative methods of computing a deduction from gross income on account of bad debts necessarily implies some difference or possible difference in the amount deductible from gross income in a particular year by a particular taxpayer; otherwise the existence of two methods is meaningless. For a practical example we need look no further than the facts of the instant case. The testimony shows that petitioner's actual bad debts during the year (exclusive of loss of $124,513.94 here in controversy) amounted to $39,589.28, yet the addition

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[7]See Appendix, page 31.

to bad debt reserve claimed by petitioner on its return and allowed by the Commissioner was $49,494.55 [R. 61, 81].

A striking example of the same kind is found in *Athol Manufacturing Company v. Commissioner,* 22 B. T. A. 105 (1931), where the actual bad debts for 1923 were only $52.30, yet the sum of $3,338.75 (1% of sales) was deducted by the taxpayer and allowed by the Commissioner.

The inevitable conclusion is that the Court below failed to grasp the significance of the existence of two different methods of computing the bad debt allowance, and thereby inadvertently fell into the error of repealing judicially the Congressional enactment which sanctions a method alternative to and very different from the charge-off method.

The Court's reliance was placed upon the last sentence of Art 23(k)-5 of the Treasury Regulations. A reading of this sentence is as illuminating as pages of argument on the point could possibly be. The sentence simply cannot be read to state or imply what the Court below apparently believed it to mean. The Treasury Department has never attempted, either by formal regulation or by administrative practice, to posit that the amount of deduction properly allowable to a taxpayer using the reserve method is the same as the deduction which would be allowable to the same taxpayer if he were using the charge-off method.

C. Neither the Statutes, the Regulations Nor Administrative Practice Requires of a Taxpayer on the Reserve Method That There Be Any "Ascertainment," "Charge-off," or Book Entries During the Taxable Year.

Section 23(k) above quoted is the sole statutory provision governing the right of taxpayers to take deductions because of bad debts. Analysis of this section readily reveals that the only language therein referring to the reserve method is that contained in the introductory phrase and the phrase within the parenthesis. The provisions of said section can be clearly demonstrated as follows:

> "In computing net income there shall be allowed as deductions: * * *
>
> "(1) Debt ascertained to be worthless and charged off within the taxable year; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction; or
>
> "(2) In the discretion of the Commissioner, a reasonable addition to a reserve for bad debts."

All reference in such section to ascertain and charge-off is inescapably tied to specific bad debt deductions as contrasted with the deduction of a reasonable addition to reserve. Because of the basic and inherent differences in the two methods, language referring to specific bad debts cannot be applied to the reserve method. Such a construction would necessarily render the section ambiguous and uncertain, would rewrite the law, and would destroy the right of taxpayers to use the reserve method.

Treasury regulations must also be read after eliminating from consideration the provisions thereof referring to specific bad debts, ascertainment and charge-off, since such terms by their nature are foreign to the reserve method. Once such inapplicable provisions are eliminated, Article 23(k)-1 of Regulations 86 provides for the treatment of bad debts "by a deduction from income of an addition to reserve for bad debts."

The remaining regulatory provisions relating to the reserve method (to the extent material here) are found in Article 23(k)-5 of Regulations 86.

It is respectfully submitted that language cannot be found in the Regulations requiring ascertainment and charge-off or book entries as a prerequisite to the right to deduct from income additions to the bad debt reserve. It is clear that the Treasury, in adopting Art. 23(k)-5, recognized the inherent difference in nature of the two methods. It further appears from the language of the second paragraph of that Article, wherein it is stated that the taxpayer using the reserve method "should" make a statement in his return showing volume of sales, accounts receivable, etc., that the Treasury was merely seeking statistics to enable it to ascertain the reasonableness of the addition to the reserve. Nothing more can possibly be constructed out of such language.

It is not reasonable to assume that the Treasury would choose such loose and indirect language to require ascertainment and charge-off or book entries as a condition precedent to the deduction, where it could easily have used explicit mandatory language.

The Treasury's failure by formal regulation to require either ascertainment, charge-off or book entries as a con-

dition precedent to the right to deduct from income a proper addition to the reserve for bad debts is paralleled by administrative practice. The Commissioner of Internal Revenue's practical interpretation that ascertainment, charge-off and book entries are not a prerequisite to such right to deduct, is disclosed by the record in this case, particularly by the testimony of the Government's witness, Mr. W. H. Bladon. Mr. Bladon, Internal Revenue Agent and Certified Public Accountant, was presented by the Government to the trial court as qualified to speak on the subject of the Commissioner's practice in his review of the returns of taxpayers using the reserve method and the manner in which the Commissioner exercises his discretion in allowing, disallowing or increasing additions to the reserve for bad debts.

Mr. Bladon's testimony is found in the record [pp. 96-103, inclusive]. We quote therefrom only the following:

> "Q. By Mr. O'Connor: You speak about a change in the reserve. What do you mean; an addition to the reserve or a decrease in the amount of the addition?
>
> A. *It may be either. A change may be either a decrease or an increase.*" (Emphasis added.)
>
> "Q. What determines the factor as to whether you think the additions to the reserve have been too much or whether you think the additions to the reserve have not been enough?
>
> A. Well, that is a condition of the reserve at the end of the year. In other words, you have certain

accounts and notes on the books, and you attempt to evaluate those notes and accounts by this reserve. In other words, you estimate there will be so many bad accounts in the account and notes at the end of the year. Then your reserve should equal the amount of the estimated loss.

Q. Are you guided by—

The Court: Just a moment. Listen to this answer very carefully and see if that is exactly what you meant to say. I want to be sure. Will you read it to him, please?

(The record was read.)

The Court: Is that correct?

The Witness: That is correct.

Q. By Mr. O'Connor: Then, Mr. Bladon, when the additions to the reserve are—the amount in the addition to the reserve is too much for a particular year then what action does the Commissioner of Internal Revenue take?

A. Well, he disallows the amount which he thinks is excessive and restores it to income.

Q. *Then when the amount of additions to the reserve are not enough for that particular year, does the Commissioner take the same action?"* (Emphasis added.)

"A. *Well, he will increase the reserve."* (Emphasis added.)

* * * * * * * *

"The Witness: In effect, yes. He doesn't instruct the taxpayer to make any entries on his books, but—

The Court: He instructs him for tax purposes that that would be the position of the Commissioner?

The Witness: That is correct, yes.

* * * * * * * *

The Court: *That visit to the taxpayer by the revenue agent might be six months or several years after the return is actually filed?"* (Emphasis added.)

"The Witness: *That is correct."* (Emphasis added.)

* * * * * * * *

"The Court: Just one other thing. *Regardless of the final outcome,* whether the tax is actually paid and the matter taken into the tax court or otherwise, *the taxpayer may or may not reflect on its books at that time the situation as indicated by the Commissioner?"* (Emphasis added.)

"The Witness: *That is right."* (Emphasis added.)

We submit that it is clear from the above that the Commissioner exercises the right to increase or decrease additions to the reserve after the close of the taxpayer's year. We submit further that the Commissioner assumes and exercises such right in the absence of book entries. Unless it can be said that the Commissioner is governed by a law different from that governing a taxpayer, it would follow that ascertainment and charge-off or book entries are not a prerequisite to the right of a taxpayer on the reserve method to secure the deduction.

D. The Petitioner Does Not Seek an Enlargement or Addition to Reserve in Light of Subsequent Events; Rather It Seeks to Apply the General Principle That Net Income Should be Computed and Taxes Paid on an Annual Basis.

It is admitted by both the petitioner and the Government that the debt in question is related solely to the taxable year 1934, and that unless petitioner's position here is sound such loss can in no way be reflected for income tax purposes.

All the facts upon which the questioned debt depended were completely ascertained within the taxable year. All the facts that could ever occur with respect to the loss occurred in the taxable year. *The debt was extinguished during such year* [R. 122]. The transaction was closed during such year.

The taxpayer, through ignorance of the law controlling the tax incidence of such transaction, failed to ascertain and reflect on its books the *amount* of its loss. Because of such oversight or neglect, this case is at issue.

The quotation [R. 142] of the court below from *Farmville Oil & Fertilizer Co. v. Commissioner*, 78 F. (2d) 83 (C. C. A. 4) is not, we submit, controlling under the facts of this case. The taxpayer there was attempting to enlarge its reserve "in light of subsequent events" and so to permit would result, under the facts there, in a deduction "in a year prior to that in which their (the debts') worthlessness would be realized."

The decision in *Consolidated Dry Goods Co. v. United States*, 35 F. Supp. 523 [R. 142], is, we submit, likewise not contrary to petitioner's position here. There the taxpayer's estimate of the reasonable addition to reserve was

"fairly made" *in light of all losses anticipated or actually occurring in such year,* and in the following year it attempted to *revise* such estimate for the sole and obvious purpose of throwing the addition, and thus the deduction from income, into the most advantageous year.

In the case at bar, all the facts and events upon which the worthlessness of the debt and amount of the loss depended occurred in the taxable year. To grant that which petitioner here seeks would not permit a deduction on account of the bad debt in a year prior to that in which the worthlessness was realized or occurred. Here evidence was submitted as to what would have been a reasonable and proper addition to the bad debt reserve for 1934, in the light of the circumstances existing at the end of that year [R. 70]. That the proper amount of the addition to bad debt reserve in any case is a question of fact is obvious. The facts that are deemed pertinent in the present case were presented by petitioner's witness J. D. Savant [R. 61-62, 66], were restated by the trial court [R. 68] and confirmed by government witness H. W. Bladon [R. 97-98]. The latter agreed that one of these pertinent facts is the amount of bad debts actually incurred during the taxable year [R. 101].

Based on this evidence (there being no conflict between petitioner's witness and the government's witness) the trial court found that the sum of $174,109.38 was, as claimed by petitioner, a reasonable addition to petitioner's reserve for bad debts which should have been made for the year 1934 [R. 41]. The government's statement of

points to be relied upon on appeal does not include any attack on this finding [R. 126-128]. It follows that there can be no complaint that the petitioner's case here is rested upon hindsight or upon factual developments which had not occurred or were not reasonably anticipated during the year 1934.

E. Congress Did Not Intend That a Taxpayer Should Be Denied the Right to Deduct Items Otherwise Deductible Because of Mere Inadvertence or Ignorance of the Law.

With a single exception, which will be discussed below, the revenue laws completely fail to require, either expressly or by implication, that a deduction which is allowable under the law must appear on the books or in the tax return in order to entitle the taxpayer to a refund on account thereof. The only questions in an action on a rejected refund claim are whether there was an overpayment of the tax and whether the taxpayer took the requisite procedural steps within the respective periods of time allotted therefor.

On the taxpayer's books for the year 1934, and in the taxpayer's income tax return for that year, the taxpayer failed to claim a deduction of the sum of $124,513.94 which the taxpayer would have included in its addition to reserve for bad debts had it not misunderstood the law to be that the particular transaction constituted a purchase of the property for a consideration equal to the amount of the debt. It was the taxpayer's understanding that no matter what the value of the property was at the time it was acquired in 1934 the taxpayer was not entitled to claim any loss until it had sold the property [R.

71]. As late as 1941 the view of the Commissioner of Internal Revenue as to the law was also erroneous.[8]

Having made this error, the taxpayer sought to correct its income tax return by filing, in 1938, a claim for refund based on the deduction which it would have set up on its books and claimed in its tax return had it correctly understood the law [R. 6, 41, 70-71].

The principle is thoroughly established that where a taxpayer has failed to set up a deduction on its books during a particular year and has failed to claim that deduction on its income tax return for that year, it is, nevertheless, entitled to a refund if it files a claim therefor at any time within three years after the return was filed. Numerous cases have allowed deductions by way of refund claims although such deductions had been overlooked entirely during the year in question and had not been claimed on the income tax return:

Hyatt Roller Bearing Co. v. United States, 43 F. (2d) 1008 (Ct. of Claims, 1930);

Huber v. United States, 16 F. Supp. 773 (Ct. of Claims, 1936);

Gimbel v. Rothensies, 24 F. Supp. 117 (Pa. D. C. 1938);

Monmouth Plumbing Supply Co. Inc. v. United States, 4 F. Supp. 349 (Florida D. C. 1933);

Saylor Elec. & Mfg. Co. v. United States, 33 F. Supp. 310 (Mich. D. C. 1939);

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[8]In *Commissioner v. Spreckels* (C. C. A. 9, 1941), 120 F. (2d) 517, the court ruled against the Commissioner's contention that such a transaction as was involved in this proceeding did not give rise to a bad debt.

Smith v. United States, 16 F. Supp. 393 (Mass. D. C. 1936);

Moore v. Hoey, 31 F. Supp. 478 (N. Y. D. C. 1940);

Chisolm v. United States, 19 F. Supp. 274 (Ct. of Claims, 1937);

Page v. Rhode Island Hospital Trust Co., 88 F. (2d) 192 (C. C. A. 1, 1937); (for more complete statement of facts, see *Rhode Island Hospital Trust Co. v. Page,* 14 F. Supp. 481);

Weintraub v. United States (Pa. D. C. 1939), Prentice-Hall, 1939 Fed. Tax Service, Par. 5.602.

The only exception to this general principle existed prior to 1942 with respect to losses on account of bad debts of taxpayers who were on the charge-off method. Commencing with the Revenue Act of 1913, taxpayers were permitted a deduction from gross income of "debts due to the taxpayer actually ascertained to be worthless and charged off within the year." Substantially the same language has remained in the law until the Revenue Act of 1942. However, by the Revenue Act of 1921 (Sec. 214(a)(7)), Congress wrote into the law authority, in lieu of charging off specific bad debts, to set aside and deduct additions to a reserve substantially as the right now exists in Section 23(k) of the Internal Revenue Code.

It is apparent from a cursory reading of the language contained in the Revenue Act of 1913 quoted above (and the corresponding provisions of later laws) that prior to the Revenue Act of 1921 losses on account of bad debts could be deducted in only one way; and further, that in order to obtain such deduction, the debt must "be ascer-

tained to be worthless and charged off within the taxable year."

Numerous cases could be cited showing substantial relaxations of the strict rule imposed by the statute upon taxpayers using the charge-off method. The record of such cases evidenced a growing conviction that the statute governing the charge-off method was unnecessarily harsh and stringent.

In 1942 Congress, by Section 124(a) of the Revenue Act of 1942, eliminated entirely the requirement of ascertainment and charge-off. The 1942 amendment permits deduction of "all debts which became worthless within the taxable year," and the change was made retroactive to all taxable years beginning after December 31, 1938 (Revenue Act of 1942, Sec. 124(d)).

This amendment made no change whatever in that portion of the section relating to the treatment of bad debts by a taxpayer using the reserve method. The reason, of course, is that the requirement so removed did not apply to the taxpayer using the reserve method.

It follows from the above that petitioner did not lose its right to the deduction merely because it failed to determine the amount thereof during the taxable year and claim the same at the time of filing its return. Our research has disclosed only two cases which announce principles controlling under the facts of this case.

In *Athol Manufacturing Company*, 22 B. T. A. 105 (1931), the taxpayer entered on its books an addition to

bad debts reserve in the amount of $8,434.75 for the year 1924. The Commissioner admitted that debts in the amount of $20,895.21 actually became worthless during the year. The Board of Tax Appeals held at the instance of the taxpayer that a further addition to bad debt reserve for the year 1924 should be allowed in the additional amount of $9,174.01, or a total of $17,608.76. This decision, rendered in 1931, thus more than doubled the allowance for addition to bad debt reserve for the year 1924, more than six years after the close of that taxable year. On appeal by the taxpayer (other points were also involved in the case) the decision of the Board of Tax Appeals was affirmed. (*Athol Mfg. Co. v. Commissioner,* 54 F. (2d) 230 (C. C. A. 1st, 1931).)

In *The Proctor Shop, Inc.,* 30 B. T. A. 721 (1934), the taxpayer claimed in its tax return for the taxable year ending January 31, 1929, an addition to its reserve for bad debts in the amount of $16,961.42. The Commissioner upon examining the return proposed to reduce this figure to $14,971.17. Some five years after the close of the taxable year the Board of Tax Appeals held that the amount which should properly have been added to the reserve was $21,776.24, a sum substantially greater than that originally claimed, and ruled that the taxpayer was entitled to have its tax liability reduced by reason of this additional allowance.

It is respectfully submitted that these two decisions correctly reflect the Congressional enactment, the Departmental regulations, and the actual administrative practice. The same principle is applicable to the instant case.

Conclusion.

Wherefore, it is respectfully submitted that this petition for writ of certiorari to reverse the judgment of the Circuit Court of Appeals for the Ninth Circuit should be granted.

Dated: September 21, 1945.

MAYNARD J. TOLL,
W. JOS. MCFARLAND,
Counsel for Petitioner.

O'MELVENY & MYERS,
Of Counsel.

APPENDIX.

Section 322(a) of the Revenue Act of 1934:

"SEC. 322. REFUNDS AND CREDITS.

"(a) *Authorization.*—Where there has been an overpayment of any tax imposed by this title, the amount of such overpayment shall be credited against any income, war-profits, or excess-profits tax or installment thereof then due from the taxpayer, and any balance shall be refunded immediately to the taxpayer."

Article 23(k) of Treasury Regulations 86, promulgated under the Revenue Act of 1934:

"Art. 23 (k)-1. *Bad debts.* Bad debts may be treated in either of two ways—

"(1) By a deduction from income in respect of debts ascertained to be worthless in whole or in part, or

"(2) By a deduction from income of an addition to a reserve for bad debts.

"Taxpayers were given an option for 1921 to select either of the methods mentioned for treating such debts. (See article 151, Regulations 62.) The method used in the return for 1921 must be used in returns for subsequent years and in returns under the Revenue Act of 1934 unless permission is granted by the Commissioner to change to the other method.

* * *

"If all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. There should accompany the

return a statement showing the propriety of any deduction claimed for bad debts. * * * Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off and allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Partial deductions will be allowed with respect to specific debts only.

"Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for the purpose of deduction. * * *

"Art. 23 (k)-3. *Uncollectible deficiency upon sale of mortgaged or pledged property.*—If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the mortgagee or pledgee ascertains that the portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off, he may deduct such amount (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it is ascertained to be wholly or partially worthless and charged off * * *

"Accrued interest may be included as part of the deduction only if it has previously been returned as income. * * *

"Art. 23 (k)-5. *Reserve for bad debts.*—Taxpayers who have established the reserve method of treating bad debts and maintained proper reserve accounts for bad debts, or who, in accordance with article 23 (k)-1 adopt the reserve method of treating bad debts, may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of a deduction for specific bad debt items.

"What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. A taxpayer using the reserve method should make a statement in his return showing the volume of his charge sales (or other business transactions) for the year and the percentage of the reserve to such amount, the total amount of notes and accounts receivable at the beginning and close of the taxable year and the amount of the debts which have been ascertained to be wholly or partially worthless and charged against the reserve account during the taxable year."

Service of the within and receipt of a copy thereof is hereby admitted this.....day of September, A. D. 1945.

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entered June 29, 1945 (R. 146). The petition for a writ of certiorari was filed on September 25, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1934 the taxpayer accepted a deed to real estate in full satisfaction of the mortgage loan on certain property and charges for taxes and other items which were secured by the trust deed. There was no appraisal of the property at that time, the property was valued on the taxpayer's books in an amount equal to the debt, and the taxpayer's deduction for a reasonable addition to its reserve for bad debts under Section 23 (k) of the Revenue Act of 1934 was made without any reference to this transaction.

The question is whether the addition to the reserve fund allowed as a deduction in 1934 may be increased by the loss disclosed as a result of an appraisal made in 1938.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations involved are set forth in the Appendix, *infra*, pp. 18–21.

STATEMENT

The pertinent facts may be summarized as follows:

On or about September 2, 1932, the taxpayer loaned $180,000 to the Hollywood Improvement Company, a corporation, then doing business in Los Angeles, California. The Hollywood Improvement Company concurrently therewith executed and delivered to the taxpayer its promissory note payable to the order of the taxpayer in the principal amount of $180,000, and executed and delivered to the taxpayer a deed of trust securing the promissory note covering certain real estate located at the southwest corner of Eleventh and Hill Streets, in Los Angeles, California. The promissory note provided, among other things, that the Hollywood Improvement Company should not be personally liable upon the promissory note or for any deficiency following sale under or foreclosure of the deed of trust. (R. 2–3, 40, par. 1.)

During 1933 the Hollywood Improvement Company failed to pay interest as provided in the promissory note and failed to pay taxes upon the property as provided in the deed of trust. Each of the defaults thereafter continued and no payment of any of the sums was made by that Company. The deed of trust provided that failure to make any of the payments should constitute a default; that thereupon the taxpayer should have the right to demand that the property be sold; and that the proceeds of such sale, after payment of expenses specified in the deed of

trust, be applied to the payment of the promissory note. (R. 3, 40, par. 1.)

Subsequent to September 2, 1932, and prior to May 15, 1934, the taxpayer paid the state and county taxes, assessments, charges for policy of title insurance, and charges for repairs upon the property, and other items, in the amount of $8,416.68, all of which, under the terms of the trust deed, the Hollywood Improvement Company had agreed were secured by the trust deed. On or about May 15, 1934, the total amount of principal and interest secured by the trust deed was $186,930 which, together with the $8,416.68 secured by the trust deed, made a total of $195,346.68. No part of the latter amount had been paid except $832.74, and on or about May 15, 1934, the difference between those amounts, $194,513.94, remained due and unpaid. (R. 3–4, 40, par. 1.)

On or about May 15, 1934, the taxpayer accepted from the Hollywood Improvement Company, in satisfaction of the indebtedness of $194,513.94, a grant deed covering the property described in the deed of trust given as security for the indebtedness. The grant deed was accepted by the taxpayer in lieu of causing a sale to be made by the trustee named in the deed of trust pursuant to the terms thereof. In order to induce the Hollywood Improvement Company to transfer title of the property described in the deed of trust to the taxpayer in satisfaction of the in-

debtedness the taxpayer, in lieu of paying the expense of a trust deed sale which it estimated at $1,600, paid to the Hollywood Improvement Company $800.[1] (R. 4, 40, par. 1.)

On or about May 15, 1934, the fair market value of the real property described in the deed of trust, including improvements, was $70,000. The improvements upon the property consisted of a building which on May 15, 1934, had a fair market value of $7,854.[2] (R. 4–5, 40, par. 1.)

The taxpayer accordingly suffered a loss of $124,513.94 on this transaction. (R. 40.)

At all times herein and since the year 1921, the taxpayer's principal business has been the purchase of contracts for the conditional sale of automobiles and the collection and receipt of payments falling due under the contracts, and no substantial part of the taxpayer's business has consisted of making loans on the security of real estate. (R. 40.) The loss of $124,513.94 occurred outside the usual and ordinary course of the taxpayer's business. (R. 41.)

At all times herein the taxpayer followed the practice of deducting from income on its income tax returns additions made to a reserve for bad

[1] The facts in this paragraph, as found by the District Court (R. 40, par. 1), were stipulated between the parties (R. 105–106, par. 2).

[2] The facts in this paragraph, as found by the District Court (R. 40, par. 1), were also stipulated between the parties (R. 105, par. 1).

debts and did not follow the practice of deducting on its income tax returns debts ascertained to be worthless. For the years 1932–1935, the taxpayer determined the amount to be added to its reserve for bad debts by surveying and analyzing its accounts receivable and estimating as accurately as possible the probable eventual loss that it would incur by reason of its inability to collect such accounts receivable in full. The taxpayer's practice for each of those years was to make such addition to its reserve for bad debts as would increase the reserve to the total amount of the loss estimated in the manner above set forth. In making such calculation it was also the taxpayer's practice to take into consideration bad debt losses actually incurred during the year. (R. 40–41.)

The taxpayer, in its federal income tax return for each of those years, deducted from gross income the total additions made by it during each year to its reserve for bad debts in the manner above stated. For the year 1934 the taxpayer made on its books and deducted from gross income on its federal income tax return additions to its reserve for bad debts in the aggregate amount of $49,595.44. In determining the amount of the additions to its bad debt reserve aggregating $49,595.44 for the year 1934, the taxpayer did not take into consideration and did not make any allowance for the loss of $124,-

513.94. (R. 41.) The taxpayer has not at any time before or since the year 1934 on its books or in its income tax returns made any addition to the reserve on account of this loss. (R. 41–42.)

At all times mentioned herein the taxpayer filed its federal income tax returns on a calendar year basis. Its return for the year 1934 reported a net income of $219,751.24 on which it computed and paid a tax of $30,215.80 during 1935. Thereafter, an additional federal income tax for the year 1934 was assessed against the taxpayer in the amount of $696.61 which, together with interest in the sum of $45.96, it paid on April 21, 1936, to the Collector of Internal Revenue for the Sixth District of California, appellant below. (R. 6–7, 42, par. 3.)

Prior to March 15, 1938, that is, on or about March 11, 1938, the taxpayer executed and filed with the Collector a claim for refund of federal income tax for the year 1934. (R. 7.) It was stated in the claim for refund, in part, as follows (R. 12):

> The officers of the Company have recently been making inquiries as to the curent market price of the property with a view to disposing of it. These inquiries indicate that if it is desired to dispose of the property at the present time (1938) considerable loss will have to be sustained. Since the general real estate market in Los

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> Angeles is apparently at as high a level in 1938 as it was in 1934, it is possible that in the event of a sale of the property the Commissioner of Internal Revenue may determine that the fair market value of the property when acquired in 1934 was not as great as $188,383.94.
>
> This claim is being filed to protect the taxpayer's rights to an additional deduction for a bad debt loss in 1934 in the event the Commissioner determines that the fair market value at date of acquisition of the property was less than $188,383.94. For purpose of determining the overassessment asserted in this claim, a valuation of $125,000.00 has been assumed, being approximately twice the assessed value as of the first Monday in March 1934.

Thereafter, on July 18, 1940, the Commissioner of Internal Revenue rejected the claim for refund, notice being mailed to the taxpayer on or after July 18, 1940.[3] (R. 7, 42, par. 3.)

The District Court found that the taxpayer did not make any allowance for the loss of $124,513.94 in determining its addition to its reserve fund in 1934 for the reason that it had construed

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[3] The District Court found the statements in the two preceding paragraphs, taken from the taxpayer's amended complaint (R. 6–7, pars. 10–11), to be true (R. 42).

the transaction as a purchase of the property for $194,513.94.[4] (R. 41.)

The District Court allowed an increase in the addition to the reserve fund in 1934 and entered judgment for the taxpayer (R. 45–48); upon the Government's appeal (R. 49), the Circuit Court of Appeals reversed (R. 131–144).

ARGUMENT

The court below correctly held that since no appraisal of the property was made until 1938 and no action was taken in 1934 to ascertain whether the value of the property was less than the debt, and no part of the debt was therefore ascertained to be unrecoverable in that year, no increase in the 1934 addition to the reserve for bad debts should be made on account of the dif-

[4] The District Court further found that at the end of the year 1934, the taxpayer knew that the indebtedness theretofore owed it by the Hollywood Improvement Company no longer existed, and that the amount by which the total of the indebtedness exceeded the market value of the Eleventh and Hill streets property on or about May 15, 1934, could not be collected or recovered from the Hollywood Improvement Company. (R. 43.) The Circuit Court of Appeals determined that there was no evidence to sustain that finding (R. 134–135), and no error has been assigned as to this.

Other facts found by the District Court (R. 42, par. 4; R. 43, par. 5 (embracing the material set forth in pars. (a) to (g), inclusive, at R. 29–35); R. 43, pars. 6–7; and R. 43, par. 9 (embracing the material included in pars. II–IV at R. 27–28)) have been omitted for the reason that they relate to an affirmative defense asserted by the Collector which is not here involved.

ference between the value of the property and the amount of the debt.

Under Section 23 (k) of the Revenue Act of 1934 a deduction is allowable for debts ascertained to be worthless and charged off within the taxable year, or in the discretion of the Commissioner for a "reasonable addition" to a reserve for bad debts. The statute further provides that when satisfied that a debt is recoverable only in part the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. Under regulations long in effect taxpayer may treat bad debts in one of two ways: (1) He may deduct specific debts ascertained to be worthless and charged off within the taxable year, or (2) he may maintain a reserve for bad debts and deduct each year a "reasonable addition to a reserve". Whatever method is elected must be adhered to in subsequent years (a taxpayer which was in business as early as 1921 being bound by the election made in that return) unless permission to change is secured from the Commissioner. See Article 23 (k)–1 of Treasury Regulations 86.[5]

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[5] The reserve method of handling bad debts was first permitted by Section 214 (a)- (7) of the Revenue Act of 1921, c. 136, 42 Stat. 227. Currently therewith I. T. 1341, I–1 Cum. Bull. 160 (1922), was promulgated which provided in part as follows (pp. 160–161):

"In case a taxpayer computes the net addition to a reserve for bad debts for a taxable year, and it subsequently appears that the net addition was insufficient, the taxpayer cannot de-

It is clear under the regulations and well settled by decisions that either one method or the other must be consistently followed. Where the reserve method is used, only a reasonable addition to the reserve fund can be deducted, no additional deduction being allowed for a specific bad debt. *Athol Mfg. Co.* v. *Commissioner,* 54 F. 2d 230 (C. C. A. 1st); *Atlantic Bank & Trust Co.* v. *Commissioner,* 59 F. 2d 363 (C. C. A. 4th); *First Nat. Bank of Omaha* v. *Commissioner,* 49 F.

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duct in the subsequent year the amount by which the net addition to the reserve for the previous year was insufficient. * * *

"* * * In other words, the entire reserve for bad debts at all times should be, to a certain extent, based upon the total amount of debts outstanding, and, in determining what constitutes a reasonable addition for any year to such a reserve, the total amount of debts outstanding and the amount of the existing reserve should be considered."

Substantially the same regulatory provisions interpretative of like statutory provisions in regard to bad debt reserves have been in effect ever since that time. Art. 155 of Regulations 62 (1921 Act), Regulations 65 (1924 Act), and Regulations 69 (1926 Act); Art. 195 of Regulations 74 (1928 Act) and Regulations 77 (1932 Act); Art. 23 (k)–5 of Regulations 86 (1934 Act), Regulations 94 (1936 Act) and Regulations 101 (1938 Act); and, thereafter, Sec. 19.23 (k)–5 of Regulations 103 (Internal Revenue Code). Since the administrative interpretation placed upon the bad debts reserve method has remained the same over a long period of time and Congress by the reenactment of the statutory provision here involved without substantial change has by clear implication ratified that interpretation, it is entitled to great weight and should not be disturbed. *United States* v. *Hermanos y Compania,* 209 U. S. 337, 339; *United States* v. *Safety Car Heating Co.,* 297 U. S. 88.

2d 70 (C. C. A. 8th); *Transatlantic Clock & Watch Co.* v. *Commissioner,* 3 B. T. A. 1064, 1066; *Marks* v. *Commissioner,* 9 B. T. A. 1047.

Moreover, if the petitioner, which used the reserve method, could nevertheless claim a deduction for a specific debt, it could not claim a deduction on account of the indebtedness here involved, for that debt was neither ascertained to be worthless nor charged off during the taxable year.[6]

It is implicit in the statute that the deduction allowed under the reserve method is an addition to the reserve fund made at the end of the year

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[6] The taxpayer's books at the beginning of the year 1934 showed the amount of "the $180,000 loan as notes receivable secured by property at 11th and Hill Street," and that "At the end of the year it showed as real estate, land and building, at 11th and Hill Streets," the transfer having been made from the notes receivable account to the asset account in that amount without any debit to the profit and loss account and credit to the bad debt reserve account or charge-off of the loss on the books. (R. 83–84.) It has been held that a taxpayer's transfer on its books of mortgage debts from one asset account to another does not constitute a statutory charge-off. *Malden Trust Co.* v. *Commissioner,* 110 F. 2d 751 (C. C. A. 1st).

The testimony shows that the taxpayer considered the transaction "as a purchase of the property for the amount of the debt" (R. 71), and that "they got title to the property and we considered it then as being an investment in real estate. They had had other transactions similar to that where they took over the property in partial settlement of accounts" without "reflecting any profit or loss until ultimate liquidation of the property received in exchange." (R. 85–86.)

which is "reasonable" in the light of the facts then known and the regulations make this clear. Article 23 (k)–5 of Regulations 86 requires that a taxpayer using the reserve method attach to his return a statement showing—

> the volume of his charge sales (or other business transactions) for the year and the percentage of the reserve to such amount, the total amount of notes and accounts receivable at the beginning and close of the taxable year, and the amount of the debts which have been ascertained to be wholly or partially worthless and charged against the reserve account during the taxable year.

This information is required in order that the Commissioner may determine whether the addition to the reserve fund is reasonable in amount in the light of the facts, and it seems clear not only that his determination is to be based on the facts submitted, but also that the Commissioner is given wide discretion in determining this issue. Where, as here, the Commissioner has accepted as a reasonable addition to the reserve fund the addition made in a particular year, it is questionable whether the Commissioner's action in refusing a subsequently claimed increase would be open to review, at least in the absence of arbitrary and capricious action. *Consolidated Dry Goods Co.* v. *United States,* 35 F. Supp. 523 (Mass.). See also *Farmville Oil & Fertilizer Co.*

v. *Commissioner*, 78 F. 2d 83 (C. C. A. 4th). But in any event it is clear that additions made at the time cannot be enlarged in the light of subsequent discoveries or events. *Farmville Oil & Fertilizer Co.* v. *Commissioner, supra; Consolidated Dry Goods Co.* v. *United States, supra.*

In the instant case the taxpayer had not determined in 1934 that the property was worth less than the amount of the debt, but on the contrary entered the property on its books at the full amount of the indebtedness and did not until 1938 appraise the property. While its failure to ascertain that there was any discrepancy is explained by its assumption that the debt was exchanged for the property and no part of the indebtedness would be considered as an uncollectible debt, the fact is that it did not know what if any deficiency there was, and would not, therefore, have been justified in increasing its reserve to reflect any deficiency.

The petitioner argues that the court below held that in using the reserve system as in the case of the specific debt system the taxpayers must ascertain the debt to be worthless and charge it off. But the decision does not necessarily go that far. While the court did say (R. 139) that under the reserve system the debt must be ascertained to be worthless and "charged against the reserve," during the taxable year, the rest of the opinion indicates that the court meant that

to justify the reflection of an item in the addition to the reserve there must be an ascertainment in the year that the addition is made that the account is uncollectible or that there is a reasonable probability that it will not be collected (R. 136), and that the addition to the reserve reflecting this fact must be made at that time. We think this is a proper construction of the statute, and in any event that the court was correct in holding that the taxpayer's discovery in 1938 that there was a deficiency did not justify a retroactive increase in the addition to the reserve.

None of the decisions relied upon by the taxpayer (Br. 24–25) is in conflict with the decision below. Whether or not a deduction claimed in a prior year may be changed in a later year on the basis of subsequent discoveries or events depends upon the terms of the provision granting the deduction. None of the cases cited deals with the problem here except *Commissioner* v. *Spreckels,* 120 F. 2d 517 (C. C. A. 9th), which holds merely that a transaction such as the one here involved may give rise to a bad debt deduction, where the taxpayer has charged off the deficiency as uncollectible in the year when the property was accepted in satisfaction of the debt.

The taxpayer contended below, as it does now (Br. 21–27), that since through ignorance of the law controlling the transaction herein it failed timely to ascertain or reflect on its books the

amount of the loss but sought to correct the situation by a claim for refund filed in 1938, it should not be denied the right of deduction merely because of such inadvertence or ignorance of the law. It may be noted that the regulations gave the taxpayer notice that any difference between the value of the property and the indebtedness should be treated as a bad debt. Article 23 (k)–3 of Regulations 86. Ignorance of the law does not warrant a taxpayer's failure timely to ascertain worthlessness and charge off a debt or make a reasonable addition therefor to its bad debt reserve within the taxable year, as required by the statute, regulations and authorities. Section 23 (k), Revenue Act of 1934; Articles 23 (k)–1, 23 (k)–3, and 23 (k)–5, Treasury Regulations 86 (Appendix, *infra*); *Farmville Oil & Fertilizer Co.* v. *Commissioner, supra; Consolidated Dry Goods Co.* v. *United States, supra.* The taxpayer cites no authority to the contrary.

The amendment effected by Section 124 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798 (26 U. S. C., Supp. IV, Sec. 23), relied upon by the taxpayer (Br. 26), can have no application herein for the taxable year 1934. That statute was made retroactive only to cover taxable years beginning after December 31, 1938. Section 124 (d), Revenue Act of 1942.

Moreover, the taxpayer's reliance on Section

322 (a) of the Internal Revenue Code (26 U. S. C., Sec. 322) (Br. 3) is untenable. That section merely deals with the period of limitations for securing refunds and has no bearing on the question here involved.

CONCLUSION

The petition presents no conflict of decisions and presents no other reason for certiorari. The petition should therefore be denied.

Respectfully submitted.

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OCTOBER 1945.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (k) *Bad Debts.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.
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> * * * * *

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

> ART. 23 (k)-1. *Bad debts.*—Bad debts may be treated in either of two ways—
>
> (1) By a deduction from income in respect of debts ascertained to be worthless in whole or in part, or
>
> (2) By a deduction from income of an addition to a reserve for bad debts.
>
> Taxpayers were given an option for 1921 to select either of the methods mentioned for treating such debts. (See article 151, Regulations 62.) The method used in the return for 1921 must be used in returns for subsequent years and in returns under

the Revenue Act of 1934 unless permission is granted by the Commissioner to change to the other method. * * *.

If all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. * * * Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off and allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Partial deductions will be allowed with respect to specific debts only.

Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for the purpose of deduction. * * *

ART. 23 (k)–3. *Uncollectible deficiency upon sale of mortgaged or pledged property.*—If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the mortgagee or pledge ascertains that the portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off, he may deduct such amount (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it is ascertained to be wholly or partially worthess and charged off. * * *

Accrued interest may be included as part of the deduction only if it has previously been returned as income.

ART. 23 (k)–5. *Reserve for bad debts.*—Taxpayers who have established the reserve method of treating bad debts and maintained proper reserve accounts for bad debts, or who, in accordance with article 23 (k)–1 adopt the reserve method of treating bad debts, may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of a deduction for specific bad debt items.

What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. A taxpayer using the reserve method should make a statement in his return showing the volume of his charge sales (or other business transactions) for the year and the percentage of the reserve to such amount,

the total amount of notes and accounts receivable at the beginning and close of the taxable year, and the amount of the debts which have been ascertained to be wholly or partially worthless and charged against the reserve account during the taxable year.

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END OF A CASE